

# *What does 'say on pay' say?*

- ✓ TARP firms now taking votes; others look to 2010
- ✓ Winning support with well-crafted CD&A
- ✓ Consequences of 'against' vote and factors proxy advisers consider
- ✓ Formats for off-season shareholder engagement

## REVISITING THE CD&A

The compensation discussion and analysis (CD&A) in your proxy statement should be as clearly written and relevant to your shareholders as possible.

Do you explain why your pay program is designed as it is? Do you show how compensation is linked to performance and your overall business strategy? Shareholders are also looking to see whether a company is rewarding executives for assuming ill-advised levels of risk – so questions like, ‘What type of behavior is our compensation encouraging?’ should be answered prominently in the CD&A.

Investors also want to see how pay compares with that of competitors. If your stock price has declined but is still outperforming your peers, this bears highlighting. For underperformers, it’s vital to show how compensation and incentives support business recovery.

Above all, make your CD&A user-friendly and plainly written. To this end, some companies are including introductory paragraphs explaining new developments from the past year.

# A new proxy landscape

When beleaguered AIG paid \$165 mn in retention bonuses to its executives in March 2009, anger over runaway compensation in an era of bailouts and plummeting stock prices reached fever pitch. Ironically, this passionate response came just a few weeks after Congress had enacted a mandatory say-on-pay shareholder vote for all companies that had accepted Troubled Assets Relief Program (TARP) funds as required by Section 111(e) of the American Recovery and Reinvestment Act (ARRA).

‘Say on pay’ – the catchy name for a non-binding resolution inviting shareholders to vote either for or against a company’s compensation of senior executives and the philosophy behind such pay – has been a cause célèbre for

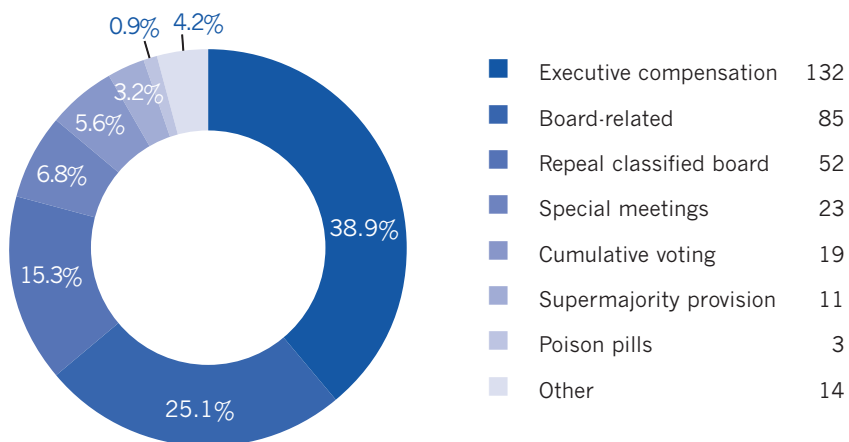
more than two years now. Although many believe it is nothing more than a vague shareholder referendum on a company’s pay practices, companies that have resisted adopting the measure now have no choice but to scramble to understand it quickly.

That said, the universe of public companies already holding a say-on-pay vote is very small. Prior to February 2009, just over a dozen firms had agreed to submit annual, non-binding say-on-pay votes to their shareholders. As of this spring, however, more than 300 public companies that received TARP money are including say-on-pay votes on their annual meeting ballots, according to RiskMetrics Group.

In addition, this proxy season, shareholders presented say on pay-related proposals at roughly 100 companies,

## Corporate governance proposals in 2008

Executive compensation proposals dominate the landscape



Source: Georganon's 2008 Annual Corporate Governance Review

including Apple, ConocoPhillips and Raytheon. Such proposals request that a company holds non-binding say-on-pay votes at future annual meetings. Since the proposals were submitted to the companies and the federal stimulus legislation was enacted, 14 of these companies are now required to hold the actual non-binding votes in 2009.

Many companies that had nearly finished their 2009 proxy statements were forced to execute a last-minute about-

## *The SEC has given strong indications it would favor making say on pay mandatory for all US public companies*

face. TARP companies quickly added say-on-pay resolutions to their proxy statements in time for shareholders to consider and then vote on them prior to their annual meetings.

As TARP companies were facing enormous time pressure to file and mail a revised proxy statement, many of them simply included very brief statements about say on pay, borrowing language straight from the statute.

Naturally, TARP companies, already facing substantial economic difficulties, view say on pay with trepidation. They fear shareholder anger over declining share prices and financial bailouts may negatively affect the vote, resulting in a high (and embarrassing) number of against votes.

### ***Out of the woods?***

Although companies that didn't receive TARP money aren't required to hold an advisory say-on-pay vote this year, they should still pay close attention to the

issue, because it looks like it might become a reality for all public companies as early as the 2010 proxy season. If so, investors will be voting on the compensation paid and the pay policies established in 2009.

One reason say on pay looks inevitable is that Representative Barney Frank introduced a say-on-pay bill in February 2006 and it passed with a 269 to 139 majority. The companion bill for the Senate never left committee, but it was sponsored by then Senator Barack Obama.

What's more, the SEC has given strong indications it would favor making say on pay mandatory for all US public companies. In recent speeches, commission chairman Mary Schapiro said giving shareholders more say on how corporate executives are paid is on the SEC's agenda.

SEC commissioner Elisse Walter has also been quoted as saying she believes say-on-pay advisory votes can help restore investor trust, so she hopes more companies will voluntarily adopt the practice. In 2009 a handful of companies, including Ameriprise Financial, Occidental Petroleum, Intel and Hewlett-Packard, did just that, voluntarily embracing a non-binding say-on-pay vote.

Separately, proponents of executive compensation reform have submitted proposals requesting that companies hold actual say-on-pay votes in the future, and these proposals have sometimes garnered attention-grabbing levels of shareholder support.

For instance, Hain Celestial investors gave roughly 62 percent of their support to a say-on-pay proposal at the natural food company's March 11 annual meeting, according to Walden Asset Management, one of the proposal's proponents. A similar proposal at the Walt Disney Company garnered 42.3 percent of the votes cast in support of the measure.

## **THUMBS-UP OR THUMBS-DOWN?**

*Some describe say on pay as a blunt instrument, nothing but a chance to take the pulse of shareholders. Others see it as a referendum on specific pay practices and/or philosophies. What your say-on-pay vote means depends on how you craft the language and frame the issues.*

*No one knows what percentage of against votes should cause real consternation, though a majority of votes cast against a company's compensation practices would be a troubling sign. Most governance experts believe even 20 percent to 30 percent of votes cast against a company's say-on-pay resolution should give management pause.*

*How a company responds to a high against tally is critical: it may be at risk of incurring shareholder ire through withhold or against votes for director nominees, particularly those on the compensation committee, if it doesn't respond decisively to shareholder displeasure expressed through a say-on-pay vote.*

## EARLY ATTEMPTS

Some Troubled Assets Relief Program (TARP) companies found themselves crafting say-on-pay language for their proxy statements in a matter of days. Given the time constraints and the controversy around the issue, many of the early adopters played it relatively safe, merely including a one-line resolution stating that their board recommended shareholders vote in favor of the company's pay practices.

For instance, in its March 6 preliminary proxy statement, Washington Banking said: 'Resolved, that the shareholders approve the compensation of executive officers as described in the CD&A and tabular disclosure regarding Named Executive Officer compensation (together with the accompanying narrative disclosure in this proxy statement).'

Other examples of say-on-pay resolutions at TARP and non-TARP companies can be found at Say on Pay 2009, a forum provided by IR magazine's sister publication Corporate Secretary with the support of the Shareholder Forum: [www.crossbordergroup.typepad.com/say\\_on\\_pay\\_forum](http://www.crossbordergroup.typepad.com/say_on_pay_forum)

# Lessons learned

Prior to Congress mandating a non-binding say-on-pay advisory vote for all TARP companies, only around 15 public firms had agreed to submit such a vote to their shareholders in 2009, according to RiskMetrics. As of early 2009, only six companies outside the TARP recipients had included this vote in their proxy statements and had results back.

In general, companies that embraced say on pay have seen a wide range of shareholder support levels. For the six firms with votes in 2008, the percentage of support from all votes cast ranged from 97.2 percent to 53.6 percent, according to RiskMetrics.

### Aflac and Jackson Hewitt

Aflac, the insurance provider, made proxy history in February 2007 when its board unanimously voted to embrace say on pay in the 2008 proxy season. Following the decision, management engaged in a rigorous investor outreach campaign to make sure shareholders understood why the company had structured compensation

the way it had.

When it came to gathering support, Aflac enjoyed several advantages, including strong operating performance and superior disclosure practices. In its first say-on-pay vote, Aflac achieved 'for' votes

*IROs and corporate secretaries eager for examples of how say on pay might work in practice are looking to the UK*

from 93 percent of the shares voted.

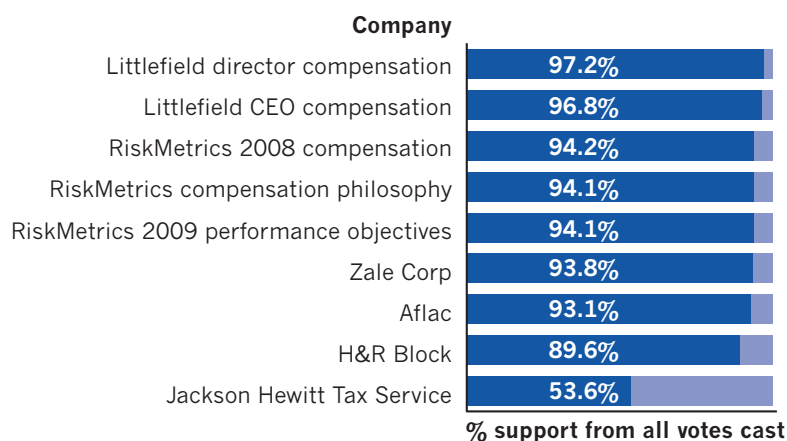
Not all companies fare so well with say on pay: tax preparation giant Jackson Hewitt got just bare majority - 53.6 percent - support from all votes cast. David Drake, president of Georgeson, a leading proxy solicitor, says the company's performance was only one factor in the lack-

### Advisory votes

Some non-TARP companies holding actual say-on-pay advisory votes

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| <input checked="" type="checkbox"/> Aflac                | <input checked="" type="checkbox"/> Littlefield          |
| <input checked="" type="checkbox"/> Ameriprise Financial | <input checked="" type="checkbox"/> MBIA                 |
| <input checked="" type="checkbox"/> Blockbuster          | <input checked="" type="checkbox"/> Motorola             |
| <input checked="" type="checkbox"/> H&R Block            | <input checked="" type="checkbox"/> Occidental Petroleum |
| <input checked="" type="checkbox"/> Hewlett-Packard      | <input checked="" type="checkbox"/> RiskMetrics Group    |
| <input checked="" type="checkbox"/> Ingersoll Rand       | <input checked="" type="checkbox"/> Verizon              |
| <input checked="" type="checkbox"/> Intel                | <input checked="" type="checkbox"/> Zale Corp            |
| <input checked="" type="checkbox"/> Jackson Hewitt       |  |

## Say on pay votes passed in 2008



Source: RiskMetrics Group

luster vote results: Jackson Hewitt was also hurt by RiskMetrics' recommendation to its institutional investor clients to vote against the firm's pay practices.

RiskMetrics criticized Jackson Hewitt's pay program for a lack of specific performance metrics. Jackson Hewitt's bonuses were tied to growth in EPS, but the company didn't say which targets executives needed to achieve to earn bonuses other than that the growth levels were 'moderately difficult' to reach.

Ideally, says RiskMetrics, a company's compensation should be based on longer-term metrics, such as total shareholder return. RiskMetrics also frowned upon Jackson Hewitt's practice of awarding time-based stock incentives, which many proxy experts say are not performance incentives but 'pay to stay' measures.

How often RiskMetrics will advise clients to come out against executive compensation practices remains to be seen, but early indications point to proxy advisory firms taking these votes very seriously. As evidence, in a March 26, 2009 report, RiskMetrics advised clients to vote against at Valley National Bancorp's advisory vote on executive compensation.

### Across the pond

Understandably, IROs and corporate secretaries eager for examples of how say on pay might work in practice are looking to the UK, where an advisory vote on remuneration tables first went into effect in 2003 with the passage of the 2002 Directors' Remuneration Report Regulations.

Generally, say on pay has not resulted in widespread negative votes for UK compensation packages, and shareholders have not muscled their way into boardrooms or hijacked the decision-making process for how executives are paid.

That said, US and UK shareholder landscapes are vastly different. For example, in the UK, simply phoning or visiting a few trade associations and large institutional investors can quickly afford the board of directors a good idea of what a large percentage of shareholders think.

Without that type of trade association culture – and with a far larger geographic territory to cover – US firms would need to engage in some innovative tactics to gauge shareholder sentiment and facilitate dialogue.

### A NEGATIVE VOTE. NOW WHAT?

*In 2003 GlaxoSmithKline (GSK) lost a say-on-pay vote with a 50.7 percent vote against. The pharmaceutical behemoth also found itself criticized in the media for its executive compensation practices.*

*The company took swift action. RiskMetrics notes that GSK made a number of reductions to its CEO's compensation package and launched an active campaign to communicate better with individual and institutional shareholders.*

*Other UK firms also ramped up their shareholder engagement efforts. Many governance experts and shareholder activists believe improved communication between investors, management and directors will be a desirable effect of widespread say-on-pay votes.*

*Stephen Davis, senior fellow at Yale University's Millstein Center for Corporate Governance and Performance, has studied the effects of say-on-pay votes at UK companies. At a recent US House Committee hearing, he noted that the GSK example 'produced a virtual overnight increase in the level of dialogue between companies and shareowners.'*

## WATCHING THE WATCHDOG

In a March 2009 market report, 'Evaluating US company management say-on-pay proposals', RiskMetrics, the most influential of the proxy advisers, said a critical step in its decision-making process will revolve around the following key questions:

- Does the company demonstrate a strong link between executive pay and performance?
- How does the company use employment agreements?
- Are severance and/or change-in-control provisions fair?
- Is the company's compensation peer group appropriate?
- Are the performance criteria and targets appropriate?
- Is there significant pay disparity among top executives?
- What sort of perks are provided to executives?
- Is the compensation disclosure clear and complete?
- Is the board responsive to investor input about compensation issues?

# Getting pay right

In the blind rush for TARP companies to craft some type of say-on-pay management proposal, the philosophical niceties are bound to be lost. Ideally, though, companies would ask themselves the big question: what is a non-binding pay vote intended to consider?

Many companies ask shareholders to vote on executive compensation as outlined in the CD&A and the associated tabular disclosures. An important question here is: which executives should you include in the vote – the top five named executives, or just the CEO?

Others might specify that shareholders are not indicating support for the compensation numbers so much as the extent and clarity of the disclosures being made. And some companies might explicitly ask shareholders to consider a company's pay philosophy and strategy, as well as whether the stated benchmarks will further the company's long-term goals.

### **What the advisers are watching**

Proxy advisory firms are bracing for an avalanche of actual say-on-pay votes. While in the past they've issued recommendations on just a handful of these votes, the advisory votes on executive compensation at the TARP companies alone will keep them busy.

Increasingly, proxy advisers are identifying aspects of an executive compensation plan they'd like to see as they make their voting recommendations. Here are some critical elements:

**A long-term view of compensation.** In the past, companies have too often tied compensation to short-term performance criteria like EPS. This is a particularly important topic now: many fret that executives at financial services firms may

have engaged in excessive risk-taking because their compensation was tied to the stock price or other short-term measures of success.

Whether the compensation committee and board are looking to the future in awarding executive compensation can be hard to determine. For this reason, a clearly written CD&A is particularly valuable.

**True pay-for-performance measures.** In general, public and union pension funds, activist shareholders and proxy advisory firms would like to see companies demonstrate clearer ties between pay and performance. Just as the SEC has repeatedly asked companies to do some soul-searching as they write their management discussion and analysis in their quarterly financial statements, pay watchdogs would like companies to explain the metrics they've chosen for granting incentive pay and discuss what behaviors they're aiming to reward.

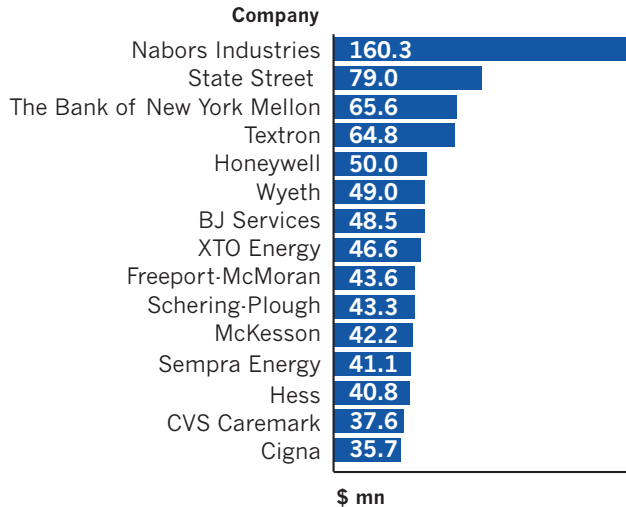
If executive compensation is growing while a company's stock price is falling, investors and proxy advisory firms are increasingly asking why. Companies with rising CEO pay during poor stock performance should expect to answer some pointed questions.

Activists and proxy advisory firms are also scrutinizing whether a company's compensation peer group is appropriate. When a company selects peers with significantly higher revenues, that choice tends to inflate median salaries. Increasingly, shareholders and proxy advisory firms are frowning upon generous severance packages and other post-termination pay as pay-for-failure measures.

**Hidden compensation and perks.** Proxy advisory firms are looking critically at pay packages that are heavily

## Top 15 tax gross-ups

Shareholders are particularly concerned about perks and other hidden forms of compensation, such as tax gross-ups.



### Potential excise tax gross-up payments, based on disclosures in 2008 proxy statements.

Source: RiskMetrics, November 2008

weighted with perks, supplemental pensions and severance benefits as these are all non-performance-based compensation elements.

One common practice has received considerable attention in recent months, especially among large public companies: tax gross-ups. The term refers to the practice of paying the taxes owed by executives for severance benefits or other perks.

The problem? Every time a company pays taxes on a perk, the taxes become taxable, and the company's bill spirals higher. Thus, gross-ups are often criticized as a hidden form of compensation that winds up costing companies far more than the gifts would have cost the executives who received them.

The solution? Make payments to executives more transparent. Instead of giving a perk and paying the associated

taxes on it, companies might just increase the executive's base pay by a corresponding amount of money.

Finally, embracing sustainable business practices may prove an important lure for some clients who want to reduce their carbon footprints by working with vendors with climate-friendly policies.

Using online workspaces can also be a recruiting tool. Many young attorneys, especially those just graduating from law school, would prefer to work at companies enlightened enough to be taking the climate issue seriously. Companies today market their diversity initiatives and pro-bono commitments to potential job candidates. Conceivably, a company's dedication to sustainable practices and its willingness to embrace the latest technology could prove an important differentiator in the not-too-distant future.

## PAY PROPOSALS ABOUND

Say on pay is just one kind of pay proposal submitted by shareholder activists this proxy season. There are others:

*Golden coffins.* Critics complain that these posthumous payments don't reinforce pay-for-performance incentives at all. As of early March 2009, non-binding proposals to curb after-death benefits had been submitted at 14 US companies, according to the Wall Street Journal.

*Bonus banks.* Companies including Charles Schwab, E\*Trade and JPMorgan Chase are being asked to create 'bonus banks' to escrow bonuses for a three-year period to ensure bonuses are not paid for short-term results that prove illusory a year or two down the road.

*Escrowing awards.* Another popular proposal asks that a substantial portion of stock grants or options awards be held for at least two years after an executive leaves the company, which may encourage CEOs to engage in succession planning and facilitate a smooth transition.

# Fostering shareholder engagement

**N**on-TARP companies are facing an extraordinary opportunity to consider how best to structure executive pay for the future. But how do you get started?

After the annual meeting, a company should work with its proxy solicitor to understand the results of any resolutions it faced, and the views of shareholders at other companies. The summer and fall provide a unique window to communicate with shareholders and lay a foundation for say on pay and other conversations likely to take place in the 2010 proxy season.

When polishing your CD&A, be sure to add any disclosures necessary to make a more favorable impression on shareholders. Often, pay practices are easier to explain in person than on paper. While identifying metrics and discussing the links between incentives and a company's long-term goals aren't easy, this exercise is important for shareholders who may soon cast an influential vote on the matter.

In 2007 Pfizer made headlines when it proposed that a few dozen of its largest investors should meet with directors for a face-to-face discussion of com-

*When polishing your CD&A, be sure to add any disclosures necessary to make a more favorable impression on shareholders*

pensation and other vital concerns. Since then, a few others have launched similar initiatives.

In October 2008, prior to the news it would be acquired by Merck, Schering-Plough announced plans to send shareholders a written questionnaire about

pay. The survey was to be mailed with the 2009 proxy materials, and results were to be discussed in the CD&A section of the annual report for the 2010 annual meeting.

Many companies don't really know how best to initiate a dialogue with shareholders about compensation. But these conversations need to take place. Consulting the governance experts at your proxy solicitor is a good way to get advice on various engagement options.

Discussions with proxy advisers are equally important: experience has shown that such meetings carry far more upside than risk.

The more engagement you have on an ongoing basis, the stronger your position on all issues. Ultimately, the critical questions are the same for all public companies. Have you understood what your shareholders are looking for in terms of executive compensation, and can you justify the compensation paid to executives?

## CORPORATE SECRETARY WOULD LIKE TO THANK OUR RESEARCH PARTNER

FOR MORE INFORMATION

Georgeson



Contact: David Drake



Phone: 1 212 440 9861



Email: [ddrake@georgeson.com](mailto:ddrake@georgeson.com)



Web: [www.georgeson.com](http://www.georgeson.com)

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